BlackRock North American Income

BRNA offers a 5% yield from a portfolio of high quality US companies…

Update
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Summary

BlackRock North American Income Trust (BRNA) offers a high level of income (currently yielding 5% on a historic basis) from a diversified portfolio of primarily large cap US equities and an extensive option-writing programme.

The trust is run by Tony DeSpirito (lead manager), Franco Tapia and David Zhao, who utilise deep fundamental research to create a portfolio of high quality, U.S. dividend-paying companies. Disciplined application of value investment principles and dividend growth are areas of focus for the managers, as they believe these elements are key to achieving long-term returns with low levels of volatility.

Income has become a particular focus for the managers following a shift of strategy in 2018 which increased the pay-out by 62% and allowed a proportion to be funded from capital. This dividend level was maintained in 2019 and at the current share price, the trust offers investors a yield of 5.0%. As well as the income from the portfolio and the use of capital reserves, the team makes extensive use of option writing to generate premiums and boost income. Currently the BlackRock team has written options to the value of 15.1% of the portfolio.

The trust has an impressive track record for total returns, typically protecting capital well in falling markets and keeping up with the benchmark and peers in rising markets. As we discuss in the **Performance section**, since the current managers took over in 2014, the trust outperformed peers and benchmark significantly. Currently BRNA trades at a discount of 6.4%.

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Analyst's View

Currently yielding 5%, BRNA is an attractive option for income reliant investors. Janus Henderson recently released a report looking at the reliability of dividends across geographies and identified the US as a **relatively safe market**. This was largely due to their strong policy stimulus in response to the pandemic, and the fact there have been no regulatory demands made on companies not to pay dividends. In addition, almost all companies pay dividends quarterly, spreading the risk of cancellations, and pay-out ratios are relatively low (buybacks are popular in the US). All this means that dividends are likely to be more resilient in comparison to UK and European companies. More specifically to the trust, BRNA also now has the capacity to pay dividends from capital. In 2019 for example, 62.5% of the full year dividend came from portfolio income, the remainder from capital and reserves.

Alongside the attractive yield, the managers have also shown a clear capacity to capture upside and limit downside. This has been illustrated over the past three years, where the trust has lost considerably less than the Russell 1000 Value benchmark in the falling markets of 2018 and 2020, whilst keeping up with the benchmark and peer group in the rising market of 2019. As such, we see the discount of 6.4% as an attractive entry point into a trust that regularly trades at a premium.

BULL
Strong track record of delivering total returns
An attractive yield and arguably more resilient dividends than other sectors
Low levels of volatility are attractive in the current environment

BEAR
Value orientated approach continues to be out of favour
Narrow discount relative to peers
Uncertainty continues to surround the US domestically and with overseas trade

Portfolio

Co-managers Tony DeSpirito, Franco Tapia and David Zhao look to identify high-quality companies, with histories of dividend growth, that trade at attractive valuations. The fuel for growing dividends in their view is healthy earnings trends and ample free cash flow generation. They believe these elements often reflect a well-managed company that consistently earns good returns on invested capital, and can also help a trust to outperform in terms of both stronger returns and reduced volatility.

There are three key differentiating characteristics of the BRNA portfolio. The first is the diversified approach to risk that the managers take. The portfolio is built up of 87 holdings, the second most in the sector and the top ten holdings (as shown below) make up just 29.5% of the portfolio, the lowest in the sector.

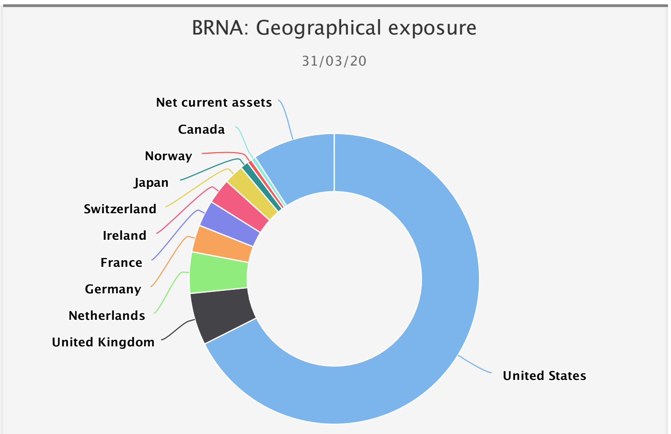
Top Ten Holdings

COMPANY	% OF NET ASSETS
Verizon Communications	4.4
Bank of America	2.9
Citigroup	2.7
Wells Fargo	2.7
Medtronic	2.5
Koninklijke Philips	2.4
JPMorgan Chase	2.4
Sanofi	2.4
FirstEnergy	2.1
Anthem	2.1

Source: BlackRock

Another key differentiating factor is the large allocation that the managers have towards companies outside out the US. They have the capacity to invest up to 20% overseas at the time of investment, although due to the performance of this part of the portfolio relative to the US, this is currently at 23.2% of the total NAV. When the managers look at companies for the US domestic portfolio, they are always compared to global competitors, and this is predominantly how overseas opportunities are sourced. An example is BP; the team believes that since the Deepwater Horizon disaster the company has cleaned up its act, and is now considerably more attractive than the US players operating in the same space.

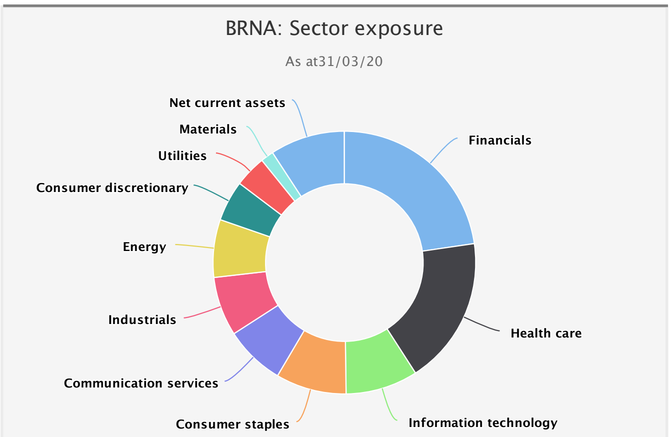
Fig.1: Geographical Allocation



Source: BlackRock

Another area of differentiation, is the tilt towards value companies. According to Morningstar, 68.7% of the portfolio is allocated towards this area, in comparison to the sector average of 36.7%. The largest sectors in which they are finding these value opportunities lie in financials and healthcare, which make up 22.7% and 18.2% of the portfolio respectively.

Fig.1: Sector Allocation



Source: BlackRock

Financials has long been the largest area of investment for the managers, and they are particularly bullish on the U.S. banks, insurers and insurance brokers. They think that U.S. banks are in a considerably stronger position than before the financial crisis, in terms of their cost structures and balance sheets, but are trading at significantly reduced valuations in comparison to other cyclical sectors. With regard to insurers and insurance brokers, they like these companies for their attractive valuations and relatively stable business models. In the case of healthcare, they believe that demographic trends are driving long term growth opportunities. In the US there is increasing demand for healthcare, as the ageing population increases, and rising costs drive a need for increased efficiency. Innovation and strong cost control can address this, and they have identified a number of companies that can contribute and benefit from this.

In order to identify these opportunities, the managers start their search by looking at the 500 largest US companies by market cap. This means the trust does have a slight bias towards large companies, with the average market cap in the portfolio of £51.1bn. The sector average in comparison is £31.3bn. From there, research ideas are sourced from two complementary sources: Input from the team's portfolio managers & research analysts and the systematic output from the team's research screen. The research screen utilizes a mix of valuation and quality factors to rank each stock in the universe. One third of the screen's factors are valuation metrics, including forward earnings, normalised earnings, cash flow and book value of companies. The remaining factors look to quantify the quality of a company, including areas like operating quality, capital allocation quality, balance sheet strength and improving trends.

After constructing a list of investment ideas, fundamental research is conducted to evaluate companies for portfolio inclusion. This includes company reporting research (financial statement analysis, examining ratios and multiples, assessment of balance sheet strength and modelling cash flows); industry research (supply and demand, competitive advantages and threats, regulatory environment and related companies); and field research (meeting with management, customers and suppliers, evaluating the strength of management, and identifying business drivers and trends). The research process is designed to identify the key drivers of the investment case for a company, and then to evaluate these key drivers using independent, data-driven analysis. Ultimately, the research analyst will translate those views into a financial model and calculate an estimated fair value for the company's stock. Just as importantly, the analyst must know where their views differ from consensus expectations and why.

Turnover in the team's portfolio is generally low, with a typical investment horizon of three to five years. Nevertheless the managers are not constrained by holding periods, and if a stock performs particularly well, breaks the investment thesis or ceases to be a compelling story, they will sell it regardless.

Gearing

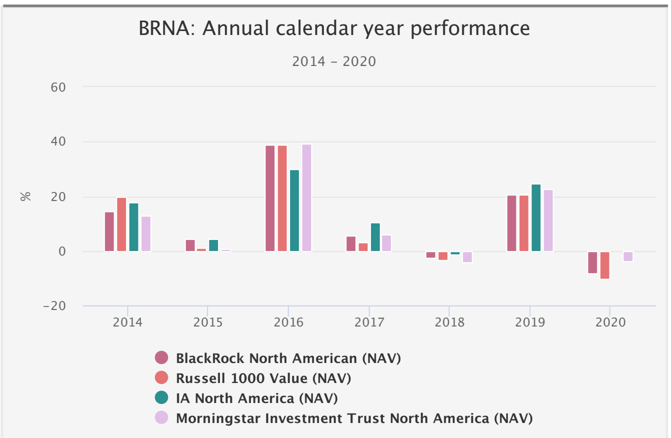
The trust is permitted to borrow up to 20% of its net assets, although in practice the board only intends to use up to 10%. We understand that to date, the borrowing facility has not been exercised, and that the managers do not anticipate using it in the near term.

Returns

The trust is still relatively new in comparison to its peers in the sector, having launched in 2012. After two years of subdued performance, Tony took over as lead-manager and since then, performance has been strong. Over his tenure, the trust has delivered NAV total returns of 90.7%, in comparison to 70.3% and 81.8% from the benchmark (Russell 1000 Value) and AIC peer group respectively.

In particular, Tony has shown his ability to benefit from rising markets, but protect capital in falling markets. This can be seen in the annual calendar returns graph below, where the trust has lost considerably less than the benchmark in 2018 and 2020. This is also reflected in the downside capture ratio of the trust (91.87%), and the standard deviation of the trust (23.05%) which are both the second lowest in the AIC sector.

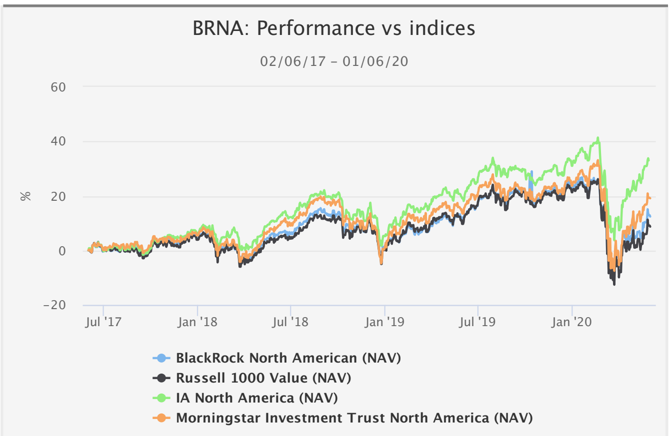
Fig.3: Returns



Source: Morningstar

Over the past three years (to 26/05/20) the trust has generated 11.6% in NAV total return terms, outperforming the Russell 1000 Value Index (7.1%) and underperforming the average trust in the AIC North American sector (17.7%). The value focus of the trust has been the key differentiating factor when assessing performance of the trust relative to peers. Growth has significantly outperformed value over the past decade, as large growth companies have deepened their 'economic moats', in particular in the US. All the while, value companies have struggled leading to a large valuation spread between value and growth stocks.

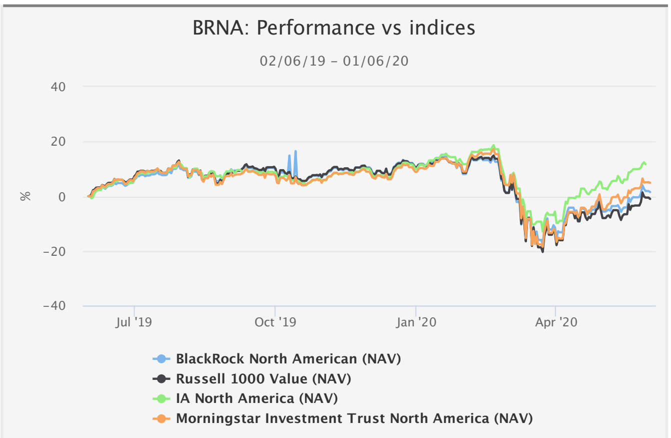
Fig.4: Three-Year Performance



Source: Morningstar

More recent performance has again been ahead of the benchmark: over 2020 the trust has returned -8.4%, compared to -11.4%. However, once more the trust has lagged the wider peer group (-4.6%). This is again a reflection of the managers valuation led style, rather than specific stock failures. The Covid outbreak has dramatically favoured growth sectors like technology, while typical value sectors like energy and financial services have struggled. However, Tony compares value to that of a coiled spring. The valuation spread between value and growth is unprecedently wide, and he believes that if they can still find companies that will grow at attractive valuations that there will be attractive long term returns.

Fig.5: One-Year Performance



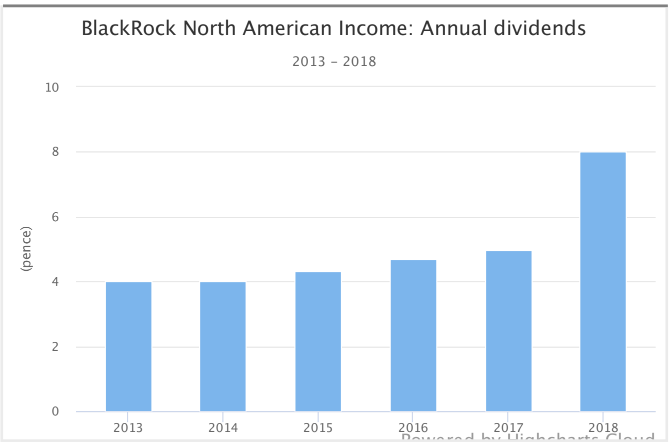
Source: Morningstar

Dividend

In 2018 the board announced a shift in the strategy, allowing a portion of the dividend to be paid from capital or reserves. This revised approach saw a dramatic increase in the dividend, to 8p per share (a 61.6% increase from the year before) which was maintained for the 2019 financial year. In the most recent full year dividend, approximately 62.5% of the dividend was covered by portfolio income, the remaining 37.5% came from capital and the revenue reserves. As we discuss in the discount section, this led to dramatic shift in sentiment towards the trust, attracting a number of new investors.

As well as the income stemming from the portfolio, the team also makes extensive use of option writing to generate premium and boost dividend income. The managers write covered options on selected holdings in the portfolio, predominantly covered calls. These allow the manager to receive an upfront premium in return for forgoing any upside on the shares they hold above the strike price of the option. Currently the options team in Boston has written options to the value of 15.1% of the portfolio (the maximum at any one time being 20%).

Fig.6: Dividend



Source: BlackRock

Management

The portfolio is managed by three co-managers, Tony DeSpirito, Franco Tapia and David Zhao. Tony has the final say, having managed the trust since October 2014. The managers have a long-term history of working together, including at Pzena Investment Management before they joined BRNA. They believe this familiarity helps their investment decisions – in particular, enabling honest and open debate during the stock selection process.

The co-managers are supported by 15 dedicated research analysts and two junior research analysts within BlackRock's US Income & Value research pillar. Franco and David serve as co-directors of research for the pillar. In this capacity they function as player-coaches, including prioritising the research agenda, training the team's analysts and modernising the research process (for example testing new tools), with a goal of continuous improvement across the whole team.

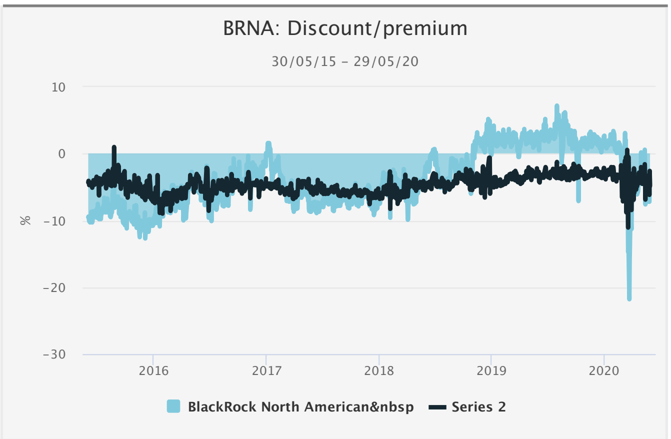
The team has a clear preference for high-quality businesses – both in terms of their management quality, but also their franchises and balance sheet strength. BRNA aims to invest in businesses which have shown a disciplined approach to paying dividends, but which in the managers' view offer significant prospects of dividend growth in years to come.

Discount

The discount of the trust has narrowed dramatically over the past two years. We think the reasons for this are twofold. Firstly, the performance of the trust has improved dramatically, in particular since the managers took over in 2014 after a difficult first two years since inception in 2012. The second was the board's decision to markedly increase the dividend (currently yielding 5%), which had a big impact on demand and led to a narrowing of a discount.

The trust traded at a premium for almost all of 2019, on average at 2.2%. However, the coronavirus pandemic saw sentiment towards the trust shift quickly, reaching a discount low of 22%. This was only momentary and since then the discount has narrowed to the current level of 6.4%. This is compares to a sector average discount of 7.4%.

Fig.9: Discount



Source: Morningstar

The board has taken advantage of the trust trading at a premium in recent years and last year 9,525,000 shares were issued from treasury, increasing the size of the trust by close to 12%.

Charges

The ongoing charges figure (OCF) for the trust is 1.09% of net assets, higher than the AIC North American sector average of 0.96%. However, this average is depressed by the extraordinarily low OCF of 0.18% for JPM American (JAM). If JAM is excluded, BRNA's OCF is lower than the resulting AIC North American average of 1.16%. The management fee is 0.75% pa, and the majority of charges (75%) are allocated to the capital account.

The KID RIY figure for the trust is 1.40%, relative to the sector weighted average of 1.25%. Again, this sector number is weighted lower by JPM American, but it is also worth noting that calculation methodologies do vary between companies.

ESG

The board and managers of BRNA recognise that ESG factors can be useful and relevant indicators for investment purposes and can support their decision making through identifying potentially negative events or corporate behaviour. The managers of the trust work alongside BlackRock's Investment Stewardship team to assess the governance quality of companies and investigate any potential issues, risks or opportunities. ESG information included within the research and due diligence on new investments and again when monitoring investments in the portfolio.

It is important to note that ESG information is not the sole consideration for investment decisions; instead, the managers look at a variety of economic and financial indicators, including ESG issues, to make investment decisions. To simplify this analysis, information is looked at through their research templates using the 'Fundamental Active Equity Risk Window'. This aids investment decisions by identifying potential ESG risks associated with a given company. Further research and engagement with companies helps to assess each risk.

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